Farm Credit Administration

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To: Board of Directors
Each Farm Credit System Institution

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Confronting the Increased Risk Environment

In October 2008, I shared with you my thoughts about challenging and turbulent economic times faced by the Farm Credit System (FCS or System) as it fulfills its critical role in serving America's farmers, ranchers, aquatic producers, cooperatives, and rural communities. The System has been and continues to be a consistent source of constructive credit and related services to American agriculture. This has been a significant factor in making the United States the most productive agricultural nation in history where Americans enjoy the safest, most affordable and abundant food supply in the world.

During the past year, the negative global economic environment and financial market turmoil have increased the uncertainty for agriculture and the System. Throughout this turbulent economic cycle, the FCS has been able to maintain financial strength and serve its mission. However, the economic and financial market uncertainty continues. Therefore, it is essential that the System maintain its financial safety and soundness to fulfill its important mission.

There is no doubt that the economic downturn and financial market turmoil are adversely impacting the agricultural and rural economies. Agricultural producers are facing greater financial challenges from lower farm income, more volatile commodity prices, higher volatility in input costs, slackening demand, and potentially changing government support priorities. Weaknesses exist in several agriculture sectors including biofuels, livestock, dairy, and land-in-transition. Also, the collapse of the U.S. housing sector has curtailed the demand for nursery and lumber products. In addition, the worsening unemployment situation reduces vital family income through job cuts and pay reduction, thus weakening loan repayment capacity, especially for part-time farmers and rural homeowners.

The upheaval occurring in the financial markets has led to fundamental changes and restructuring that are now underway and will further increase uncertainty for the foreseeable future. This situation has resulted in the System facing unprecedented risk in its access to liquidity and obtaining term financing through the capital markets.

While the System has remained safe and sound, the challenges going forward are many. As you deal with increasingly demanding agricultural and financial market conditions, there are several issues that you should emphasize as directors of your institutions.

Financial and Capital Management

Financial and business planning and management should direct business activities in a thoughtful, straightforward, and constructive manner, considering current environmental factors and emerging risks. Reassessing the current lending and financial environment is needed to ensure realistic and meaningful institution business and capital plans that focus on:

1. Managing asset growth and use of funds to focus organizational lending activities on agricultural credit needs.
    a. Ensuring eligible, creditworthy borrowers (including young, beginning, and small farmers and ranchers) in the institution's chartered territory are served first and foremost.
    b. Ensuring capital market loans/syndications, land-in-transition loans, similar entity transactions, and participations meet risk management objectives.
2. Implementing effective, proactive risk management activities to identify and control risk in today's economic environment.
    a. Placing additional emphasis on portfolio management.
    b. Placing emphasis on robust stress testing, including loan stress testing at origination.
3. Re-evaluating and adjusting underwriting standards for risk by type of credit and competency of institution staff.
4. Ensuring the allowance analysis includes well-documented, forward-looking factors to fully identify "incurred losses" as allowed by GAAP.
    a. Using judgmental, forward-looking/leaning factors in the provisioning of loan losses.
    b. Relying on historical losses to identify "incurred losses" is not, in and of itself, an acceptable or sufficient approach.
5. Re-evaluating and adjusting loan pricing practices to increase earnings and ensure loan interest rates and structure fully reflect all risks in the marketplace.
6. Reducing leverage through balance sheet management strategies by re-evaluating earnings retention and patronage programs to maintain and increase financial strength and risk-bearing capacity through higher capital levels. Focus on reducing overhead and unnecessary expense to enhance earnings and build capital.

Credit Risk

Preparation should be made for increased credit risk by:

1. Conducting stress tests that are specific to, and that fully address, risk factors faced by each institution in its portfolio.
2. Actively identifying and proactively servicing high-risk assets.
3. Identifying strategies to manage the potential increase in distressed credits, including developing specific and tailored plans for potentially high-risk assets.
4. Updating policies and internal controls for providing borrower rights and responding to complaints.
5. Increasing the expertise, training, and activities of lending staff to focus on managing increased delinquencies, borrower rights actions, and loan collections.
    a. Organizing and staffing Special Assets Units as needed.
    b. Updating policies, practices, and infrastructure.

6. Increasing the scope of internal credit reviews to ensure accuracy of risk ratings, loan servicing plans, and stress test analysis.

Compensation and Human Capital Programs

Re-evaluate executive compensation and employee incentive programs by:
1. Ensuring your board and compensation committee exercise prudent judgment in establishing and maintaining compensation and benefits programs for senior officers and employees.
2. Re-assessing performance metrics and incentive programs to ensure they reflect realities of the current environment and are consistent with business planning goals and objectives.
3. Ensuring bonus programs that promote profitability also promote strong credit administration and reward effective loan workout/collection practices, including compliance with borrower rights.

Ensure human capital plans support the recruitment and retention of people with the skills, experience, and judgment needed to manage an environment of weak credit conditions and troubled loan resolutions by:
1. Focusing staff training on developing the skills needed in an increased risk environment.
2. Re-evaluating and challenging the institution's culture to ensure it is focused on "credit, earnings, and capital" as opposed to "marketing and growth."

Funding and Intra-System Risk Management

Support initiatives that enhance overall System access to the debt markets and active collaboration across the System to address systemic risk issues by:
1. Considering initiatives that increase and stabilize System funding programs and liquidity positions.
2. Enhancing risk management, data collection, and data use across the System with the goal of improved risk management, reduced reputation risk, and minimized potential disruptions in accessing the financial markets.
3. Encouraging System collaboration and coordination on business strategies, consistency in financial reporting, and lending activities.

In closing, it is critical that we all re-emphasize the issues of financial and capital management, credit risk, compensation and human capital programs, and funding and intra-System risk management during these turbulent times. Successfully addressing these fundamental topics will help the System manage through an increased risk environment. In so doing, the System will be well positioned to provide constructive credit to creditworthy farmers and ranchers, their cooperatives, and other eligible borrowers under the Farm Credit Act. FCA will continue to support the System in fulfilling that mission.

Copy to: Chief Executive Officer
Each Farm Credit System Institution